Impact of Different Leverage Ratios on the Development Status of the Company

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Abstract. Nowadays, real estate is an integral part of the national economy and plays an important role in various aspects. Contemporarily, with fast growing economy, real estate companies often lead to high leverage and high debt due to the size of their capital and operational risks. However, with the adjustment of national policies, the development of low leverage and deleveraging is encouraged. In this study, we will take Evergrande Group and Huarun as examples to explore the differences in the development paths as well as routine of companies under different leverage models and the reasons that lead to the different development outcomes. Overall, these results explore the different impacts of different leverage models on the companies and further explore measures related to the healthy operation of the companies, which can play a positive role in the healthy development of the real estate industry as well as shed light on guiding further exploration of real estate industry.

Keywords: Real estate companies, high leverage, low leverage, Evergrande Group, China Resources Land.

1 Introduction

The last decade or so has been a prosperous period of rapid development of real estate, which has played an important role in the rapid development of China's economy. Based on the nature of the real estate industry itself, the large amount of capital scale, high financial risk, etc., in order to squeeze a larger market share, domestic real estate companies generally adopt the economic model of high leverage and high operation, which leads to the company's vulnerability to high indebtedness, thus generating high-risk crisis events. Real estate, as an important part of the market, has been exposed to serious leverage problems in recent years, which has dealt a blow to the national economy, and in order to balance the development of the national economy, the state has formulated policies to support low leverage and deleveraging, and various real estate companies have changed their business models to low leverage and deleveraging [1].

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To offer a better understanding, we further analyze the real estate industry by comparing domestic and foreign literature, real estate companies are developing rapidly, real estate and leverage are closely related. Besides, the stability of real estate prices and leverage has a very important role in China's financial and economic markets [2, 3], but at the same time, the economy is one of the problems facing China at this stage, and it is not possible to simply reduce leverage and the government, banks and enterprises need to work together to regulate the leverage ratio of real estate [4, 5]. Based on the study of Evergrande Group's debt crisis from the perspective of capital chain, Evergrande Group's capital use is not rigorous enough and has been maintaining high debt as well as external financing for its operation. Thus, Evergrande has achieved obvious results in deleveraging from four aspects, i.e., stock debt, financing structure, cash flow and financial performance [6-8]. From the above findings, we have obtained a large number of research bases and research support to prove that nowadays leverage models play an important role in the development of the real estate industry, and our research on different leverage models helps us to better understand the current situation and development trend of the real estate industry, and can also provide a better outlook for the future development of the real estate industry.

This study takes Evergrande Group and China Resources Land as examples, and compares the impact of high and low leverage on the development of the companies from the different leverage models of the two companies. Based on the analysis of different leverage models, we analyze the development status of the real estate industry, look for the hidden risks and advantages under different leverage models, and propose corresponding solutions to the possible problems. By drawing on the Evergrande crisis, one can propose a warning preventive role for other companies and adjust the operation mode of corporate capital chain, so as to play a positive role in the healthy development of the real estate industry.

2 Methodology

The data analysis method used in this paper is mainly chart analysis method, as shown in Fig. 1, which compares the financial situation of Evergrande Group and China Resources Land in recent years, and analyzes the problem through Evergrande Group's data table about "three red lines", providing chart data to compare and analyze the results and advantages and disadvantages of Evergrande and China Resources adopting two different levers. As presented in Fig. 1, we also uses literature analysis to find data on Evergrande Group's and China Resources Land's interim reports and annual reports issued within the last ten years involving the companies' operating conditions, financial review, business review, outlook, and equity composition. The group compares the research literature on real estate leverage and the relevant financial statements and other data of the two companies in the last two years to compare the advantages and disadvantages of the two financing strategies.

The comparative method is an analytical method that suggests the difference between actual and base figures by comparing them to understand the achievements and problems of economic activities. As shown in Fig. 1, the team studied the financing strategies and the development of two typical companies through the comparative analysis method and used the literature analysis method in combination with the relevant literature to derive the advantages and crises brought by the financing strategies, corporate risks, corporate development stability and the choice of different leverage multiples of other real estate companies. As depicted in Fig. 1, this study will focus on the debt and financing data disclosed in the financial statements and operational data of the two companies, and use comparative data analysis to explain the different reasons for the high and low leverage financing models adopted by Evergrande and China Resources Land respectively. We also analyze the leverage multiples and development patterns of the real estate industry in general by referring to the data and patterns of the rest of the real estate industry in the relevant literature, such as return on net assets, gearing ratio, and financial leverage coefficient. Finally, a clear understanding of the relationship between the choice of leverage multiples and operating conditions is generated.

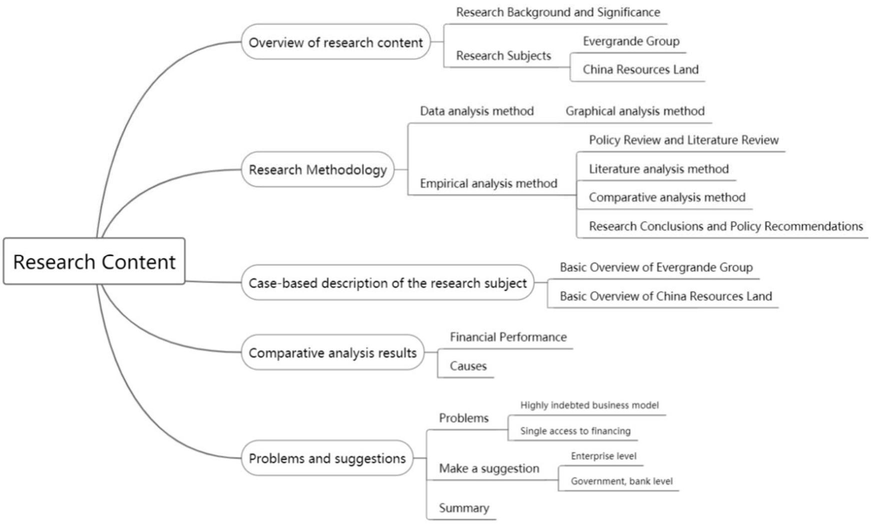

Fig. 1. Research content.

3 Descriptions

China Evergrande Real Estate Group Limited is the holding company of the China Evergrande Group and the main business theme of the Group. It was established in 1997 in Guangzhou, Guangdong Province, China. From 1997 to 1998, the company bucked the Asian financial turmoil and adopted a strategic model of "short, flat and fast" to become one of the top ten real estate enterprises in Guangzhou. 2000 to 2002, Evergrande Real Estate Group carried out effective resource integration, standardized the development process and developed several projects in the Guangzhou area and developed a few projects, ranking sixth in Guangzhou real estate enterprises. From 2003 to 2005, after the accumulation of the first two stages, Evergrande put forward the call of "second venture" and started to lay out the whole country. 2006 to 2008, the brand made substantial leaps and bounds, advancing to more than 20 cities such as Guangzhou, Tianjin, Chongqing, and Shenyang and achieving excellent results. 2009 to 2020, Evergrande laid out more than 80 cities and achieved excellent results. Evergrande has laid out more than 80 cities and has more than 150 projects. During the period of more than 20 years, Evergrande was successfully listed on the Hong Kong Stock Exchange in November 2009, with a premium of 34.28% on that day, setting a record total market value of HK$70.5 billion and becoming the overseas enterprise with the largest market value established in the Mainland in Hong Kong. After the State promulgated the "three red lines" policy, Evergrande began to be frequently exposed to problems such as a high debt ratio and an extreme lack of cash flow.

China Resources Land Limited, a property company under the China Resources Group, is one of the most powerful property developers in Mainland China. In March 2010, Hong Kong Hang Seng Index Company Limited included China Resources Land as a constituent stock of the Hang Seng Index. In 1994, China Resources Enterprise took a stake in Beijing Huayuan Real Estate Co Ltd, entering the property industry through financial control. In 1996, the company was renamed China Resources Beijing Land Limited and listed on the Hong Kong Stock Exchange in November. 2002, the company changed its name to China Resources Land Limited and confirmed its national development strategy, starting to enter Shanghai and Chengdu. 2005, the company restructured its property business, transforming China Resources Land from a residential developer to a comprehensive property developer. 2014, the company released its commercial property strategy, striving to become "China's commercial property leader". 2020 Spun off its commercial operations and property management business to establish China Resources Vientiane Life Limited, which was officially listed on the Main Board of the Hong Kong Stock Exchange.

4 Comparisons

4.1 Impact of Leverage Ratio on Financial Position Results

Firstly, when it comes to real estate companies, the issue of leverage has to be mentioned. Almost all real estate companies have leverage or gearing ratios of at least 50%, and Table 1 shows a visual comparison of the corporate gearing ratios and other ratios of Evergrande Real Estate and China Resources Land. Seen from the Table. 1, Evergrande Group's gearing ratio has remained high at over 80% every year, which indicates that the company will be under great pressure in its daily operations. The current ratio and quick ratio have basically maintained a continuous downward trend from 2017 to mid-2021, with short-term debt servicing pressure, lack of liquidity and slow capital turnover gradually coming to the fore. Current liabilities account for over 70% of Evergrande's liabilities, which to a certain extent also shows Evergrande's strong reliance on short-term funds and the high risk of debt repayment, which will lead to serious problems such as a broken capital chain and untimely debt repayment once the enterprise's funds are not sufficiently supplied. Meanwhile, the equity multiplier is the inverse of the shareholders' equity ratio, which indicates how many times the total assets are the total shareholders' equity. The equity multiplier reflects the amount of financial leverage a company has, and the larger the number, the smaller the proportion of capital invested by shareholders in the assets, which means that the company has a lot of financial leverage. A comparison shows that CR Land's equity multiplier has always been below 5, while Evergrande's equity multiplier has always been around 15. So, this high debt and high leverage has caused Evergrande Group to have problems with its business operations. A paper published by Shen in 2021 likewise verified the relevance of leverage on corporate financial impact, with real estate companies in an overall highly leveraged environment, where too much leverage can instead inhibit long-term financial as well as performance growth [4].

Table 1. Comparative table of the financial position of Evergrande Group and China Resources Land

Statement of Financial Position of Evergrande Group and China Resources Land										
	2017		2018		2019		2020		Mid-2021	
	EG	CR	EG	CR	EG	CR	EG	CR	EG	CR
Total assets	17600	4805	18800	6557	22100	7699	23000	8690	23800	9216
Total liabilities	15200	3362	15700	3987	18500	5341	19500	6128	19700	6555
Equity capital	2422	1442	3086	1589	3585	2358	3504	2562	4110	2660
Gearing ratio(%)	86.25	69.98	83.58	72.44	83.75	69.37	84.77	70.51	82.71	71.13
Current Ratio	1.404	1.393	1.359	1.328	1.368	1.324	1.264	1.293	1.242	1.32
Quick Ratio	0.525	0.457	0.416	0.449	0.384	0.420	0.331	0.444	0.336	0.477
Equity multiplier	15.35	4.103	14.14	4.739	15.14	4.377	15.66	4.271	12.46	4.416

4.2 Causes of the Impact of Leverage on Financial Position

Liu claimed that a large part of real estate leverage is expressed in the debt burden of a business [3]. When a company has financial problems, leverage is increased through external financing to keep the company running, but then there is a non-direct impact in that the profits that the company can make are reduced, so the company takes on debt which in turn leads to a further increase in leverage. Although this is a very effective way in the short term, in the long term the increase in leverage will lead to an increase in the size of corporate debt and a significant increase in the instability of the financial system, and when real estate price bubbles continue to occur, a rapid increase in the level of corporate financial stress will be observed [3]. More money as well as revenue is used to pay off debts leading to a sub-healthy state of business operations, and this is one of the main causes of the Evergrande crisis. Meanwhile, one notices that CR Land's equity multiplier has been maintained below 5, and has a healthier corporate operating model compared to Evergrande. The lower leverage ratio may limit some of the company's growth rate, but it also makes the company's growth much more stable. As the company proceeds with its strategic planning, this business model and the benefits of low debt led to steady progress and reduce the likelihood of a financial crisis.

Another possible reason for Evergrande's crisis is that the state has promulgated the "three red lines" policy, and Evergrande has touched all three red lines. The "three red lines" mainly include: firstly, the gearing ratio after excluding pre-receipts. The second net debt ratio is greater than 100%; the third cash to short term debt ratio is less than one times. The Table 2 shows Evergrande Group's data on the "three red lines" from 2017 to June 2020. At the same time, the country has classified property companies into four grades: "red, orange, yellow and green". The "green grade" refers to real estate companies that have not touched a single red line; the "yellow grade" refers to companies that have touched one red line; the "orange grade" refers to companies that have touched two red lines, the "red grade" refers to companies that have touched two red lines; The "red grade" is a company that has touched three red lines [6]. In the face of the state's policy, Evergrande Group could not expand further through leverage and high debt ratio. with the frequent outbreak of problems, it eventually led to the Evergrande crisis.

Table 2. Evergrande Group's data on the “three red lines”.

Evergrande Group's data on the “three red lines”			
Year	Gearing ratio excluding pre-sales (%)	Net debt ratio (%)	Cash to short term debt ratio
2017	83.79	184.86	0.43
2018	83.58	153.77	0.41
2019	83.75	160.60	0.40
2020	84.77	152.89	0.47
2021.6	82.71	99.87	0.36

5 Existing Problems & Solutions

The high-debt business model has become the status quo. This study analyzed the financing situation of Chinese real estate and found problems. The situation is that the current financing of Chinese real estate enterprises mainly relies on creditor's rights financing which lead to a high debt operation of real estate companies. According to public statistics, by the end of the first half of 2011, the average asset-liability ratio of listed real estate enterprises had reached 71.28% [9]. In 2015, it reached a much higher percentage at 77% [10]. The total liabilities of listed real estate enterprises are 1.24 trillion yuan, and the total assets are 1.73 trillion yuan. The total liabilities increase by 151.4 billion yuan compared with the end of last year, and the asset-liability ratio has reached its peak value in nearly ten years [9]. There is a single source of financing of real estate companies. The single financing channel is the big soft spot of real estate in our country. Liu Hongyu, an influential professor from Tsinghua University, holds that in the mature real estate industry, the main source of funds for developers is not indirect loans or direct issuance of stocks, but self-financing through long-term bonds, trust funds and mutual aid associations [9].

From enterprise level, the real estate company cannot avoid the behavior of debt due to the need of financing for enterprise development. In order to realize the healthy development of the real estate industry, from the enterprise level, enterprises must find out the appropriate leverage ratio range when making financial decisions. Be cautious during the expansion phase, broaden financing channels, and do not focus on large amounts of debt. Optimize the asset structure, use a variety of ways to achieve business expansion, increase the scale of enterprise development through cash flow, realize the benign operation of the enterprise, and then reduce the risk to the minimum. Real estate enterprises can choose financing methods according to their own scale. The size of real estate enterprises to a large extent determines the size of their assets, which also determines their solvency to a certain extent. For large real estate enterprises such as Evergrande and Huarun, if they have enough debt paying ability, they can carry out a certain ratio of debt financing and flexibly use a variety of financial products in line with national standards and the company is able to bear, so that the development of the enterprise is in a sound situation. For small and medium-sized enterprises with average solvency, they can prepare to go public for equity financing or issue high-quality trusts to make steady progress. For governments and banks, the government and banks should also provide more policy and financial support while controlling the leverage ratio of the real estate industry to help enterprises achieve steady development and jointly maintain the healthy development of the real estate industry.

6 Conclusion

In summary, taking Evergrande and Huarun as examples, this paper conducted research on the two companies through literature investigation, comparative analysis, empirical analysis, and necessary data analysis methods, and compared the impact of high leverage and low leverage on the two enterprises, so as to deduce the development path more suitable for real estate enterprises. According to the analysis, companies in the high-leverage mode are prone to problems such as high pressure to repay funds and unhealthy financial conditions, while those in the low-leverage mode are more stable and conducive to long-term development. The problem of high debt will lead to a large amount of funds used to pay off debts, which makes the development of enterprises in a high-risk state. On the contrary, the funds of enterprises with low debt can be used to improve the internal management and investment plan of enterprises, so that the development of enterprises has a trend of low risk. Although enterprises have faster development speed and can effectively expand the scale of enterprises under the high-leverage business model, the risks brought by excessive leverage may also be unable to bear. The low-leverage model may be much more limited in its speed of development, but sufficient cash flow and healthy debt can help companies tide over risks when they come. Therefore, in the face of the choice of leverage mode, enterprises should comply with national policies, and combine their own development situation to choose a suitable business model for their own development. Nevertheless, the qualitative research method adopted in this paper is based on the data of a small number of typical cases. This conclusion is not necessarily universal, and it cannot be ruled out that some real estate companies that adopt the high-leverage financing model may operate well. In addition, when writing this paper, the opinion is affected by personal professional cognition, understanding ability and other subjective factors. For further study, one will shift our research scope from the two special cases to more real estate companies and focus on the financing models of more real estate companies. Overall, these results offer a guideline for the real estate enterprises to think about their own financing mode. Real estate enterprises can better plan their own development after understanding the financing mode and development of the two special cases.

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